Comptroller of the Currency
Administrator of National Banks

Related Organizations

Comptroller's Handbook
(Section 407)

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Management

Related Organizations (Section 407)

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Related Organizations (Section 407) — Introduction

The examination of related organizations must be of sufficient scope to determine compliance with law and to evaluate the bank's investments through appraisal of related organizations' assets, earnings, and management. In addition, the examination must fully disclose the nature of the relationship between the bank and its related organizations and its effect on the affairs and soundness of the bank.

Forms of Related Organizations

Various laws, rulings, and regulations have encouraged the expansion of bank services through the formation or acquisition of related organizations, for example:

- 12 CFR 5.34 sets forth the position that, under 12 USC 24(7), banks have the "incidental powers" to acquire and hold at least 80 percent of the outstanding voting stock in a corporation so that the corporation may be designated an "operating subsidiary" of the bank.

- Specific statutes authorize investments in various statutory subsidiaries.

- Federal Reserve regulations permit investment in Edge Act and Agreement corporations.

No matter what the legal organization, a satisfactory relationship between a bank and its related organization(s) is essential to the bank's sound operation. Related organizations may assume several forms. They may be categorized as:

- Affiliates.
- Operating subsidiaries.
- Statutory subsidiaries.
- Agricultural credit corporations.
- Edge Act and Agreement corporations.
- Domestic subsidiaries.
- Foreign subsidiaries.
- Significant subsidiaries.

- Associated companies.
- Bank holding companies.
- Other related organizations.

Affiliates

There is no standard definition of the term “affiliate.”

Under 12 USC 221a, the term “affiliate” is defined to include any corporation, business, association, or other similar organizations:

- Of which the bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the shares voted in the preceding election of directors, trustees, or other persons exercising similar functions, or controls in any manner the election of a majority of the directors, trustees, or other persons exercising similar functions;

- Of which control is held, directly or indirectly, through stock ownership, or in any other manner, by the shareholders of the bank who own or control either a majority of the shares of such bank or more than 50 percent of the shares voted in its preceding election of directors or by trustees for the benefit of the shareholders of any such bank;

- Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one bank; or

- Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a bank or more than 50 percent of the shares voted in the preceding election of directors of a bank, or which controls, in any manner, the election of a majority of the directors of a bank, or for the benefit of whose shareholders or members, trustees hold all, or substantially all, of the capital stock of a bank.

This definition is used to determine compliance with 12 USC 377 (the Glass-Steagall Act), which prohibits a bank’s affiliation with a company engaged in the distribution of securities. (See a copy of the law for more specific details.)

Title 12 USC 371c (also referenced as Section 23A of the Federal Reserve Act) contains a slightly different definition of the term “affiliate” than that found in 12 USC 221a. For the purposes of 12 USC 371c, affiliate is defined to include, but is not limited to:

- Any company that controls the bank and any other company that is controlled by the company that controls the bank.

- A bank subsidiary of the bank.

- Any company that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank.

- Any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the bank or any subsidiary or affiliate of the bank.

Five types of companies are excluded from the definition of affiliate for purposes of this act and are, therefore, not subject to the limitations. Those companies not considered affiliates include, but are not limited to, any nonbank subsidiary of a bank (unless the Federal Reserve Board determines that it should be treated as an affiliate) and any company engaged solely in holding bank premises or conducting a safe deposit business. [For a complete definition of the term “affiliate,” see 12 USC 371c(b).]

Transactions governed by 12 USC 371c are referred to as “covered transactions.” Covered transactions include, but are not limited to: (1) a loan or extension of credit to an affiliate; (2) a purchase of or an investment in securities issued by an affiliate; (3) or a purchase of assets (including assets subject to repurchase) from an affiliate, except real or personal property exempted by the Federal Reserve Board. The statute states, in part, that for any one affiliate, the aggregate amount of covered transactions with a bank and its subsidiaries may not exceed 10 percent of the bank’s capital stock and surplus. For all affiliates, the aggregate amount of covered transactions with the bank and its subsidiaries may not exceed 20 percent of the bank’s capital stock and surplus.

Under section 371c(a)(4), any “covered transaction” (whether or not exempted from being governed by other paragraphs) must be made on terms and conditions that are consistent with safe and sound banking practices. Note, however, that while the purchase of an asset from an affiliate is a "covered transaction," the sale of an asset is not. Therefore, it is not subject to the restrictions of this statute. Under this strict construction, a transaction in which Bank L sells an asset to Company K (which is owned by the same holding company) at a price below fair market value cannot be cited as a violation of Section 371c or Section 23A by Bank L, even if it is judged unsafe and unsound for Bank L.

Other sections of the statute prohibit the purchase of low-quality assets from an affiliate. Low-quality assets are generally defined as substandard, doubtful, loss, other assets especially mentioned, or delinquent. Certain transactions with affiliates must also meet specific collateral requirements.

On August 10, 1987, the Federal Reserve Act was amended to include Section 23B (12 USC 371c-1), which further restricts transactions with an affiliate. It provides that a member bank and its subsidiaries may engage in specific transactions with affiliates only on terms and under circumstances (including credit standards) that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or in the absence of comparable transactions, on terms and under circumstances (including credit standards) that in good faith would be offered to or would apply to, nonaffiliated companies. The term "affiliate" is defined the same as in Section 23A, with one notable exception—it does not include any bank. Therefore, Section 23B does not apply to any inter-bank transactions.

Transactions to which the restrictions apply, include, but are not limited to: (1) any covered transaction, which has the same definition and exemptions as in Section 23A; (2) the sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase; or (3) the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise. Given the previously stated example where Bank L sells an asset to Company K (which is owned by the same holding company) at a price below fair market value, Bank L is probably in violation of Section 23B of the Federal Reserve Act. (Refer to a copy of the statute to determine applicability to any specific transaction.)

Operating Subsidiaries

As defined by 12 CFR 5.34, operating subsidiaries are corporations in which the bank owns at least 80 percent of the voting stock and which may only perform functions the parent bank is legally authorized to perform. The OCC requires a national bank which intends to acquire, establish, or perform new activities in an operating subsidiary, to submit a letter of notification to the District Deputy Comptroller. The letter must detail the proposed activities of the operating subsidiary and state whether any of those activities will be conducted at some location other than the main office or a previously approved branch of the bank.

The bank may establish, acquire, or perform new activities in an operating subsidiary 30 days after the OCC receives the bank's letter, unless instructed otherwise. All operating subsidiaries must be examined concurrently with the regular examination of the parent bank, unless the OCC specifically waives such examination under the provisions of 12 USC 486. Subsidiary companies that are owned or controlled by operating subsidiaries acquired by a national bank pursuant to 12 CFR 5.34 are to be treated in the same manner as if they were acquired directly by the bank.

Transactions between the parent bank and its operating subsidiary are not subject to the limitations contained in 12 USC 371c. However, book figures for operating subsidiaries must be consolidated line-for-line, after the elimination of inter- company items, with those of its parent to apply applicable statutory limitations and to prepare the report of examination. Each schedule in the report of examination must be prepared to reflect the combined figure of the bank and its operating subsidiaries; and, in analyzing the bank's condition, consolidated figures should be used. If the bank owns less than 100 percent of the voting stock of an operating subsidiary, consolidation will produce the liability account "minority interest in operating subsidiaries."

Statutory Subsidiaries

Statutory subsidiaries are formed under the authority of specific statutes. A statutory subsidiary may be acquired or established without prior approval from the OCC, but certain prior notification and reporting requirements apply to international activities. Those requirements are discussed in subsequent paragraphs. There is no requirement that the bank own 80 percent or more of the voting stock. Additionally, the authorizing statute may limit the amount of the bank's investment in a statutory subsidiary. The following may be acquired or established as statutory subsidiaries:

Type of subsidiary	*Authorizing and limiting statute*
Bank Service Corporation	12 USC 1861 through 1865
Safe Deposit Corporation	12 USC 24
Corporation Holding Bank Premises	12 USC 371d
Small Business Investment Company	15 USC 682(b)
Corporation Authorized Under Title IX of the Housing & Urban Development Act of 1968	12 USC 24
Agricultural Credit Corporation	12 USC 24
Foreign Branches and Banking	12 USC 601 and 618
Corporations Engaged in Foreign Banking and Financing	12 USC 618
Subsidiaries Acquired Through a DPC Transaction	12 CFR 1.12
Foreign, Non-Financial Companies Acquired through a DPC, Debt-for-Equity Swap Transaction	12 USC 24 and 29

Statutory subsidiaries are to be examined except when relationships between the subsidiary, its parent, and other related organizations can be fully disclosed with the material on hand, and the subsidiary's condition or operations are not detrimental to the safety and soundness of the bank.

Factors that should be considered in making the determination to examine a subsidiary are:

- The percent of ownership and dollar amount of the bank's investment in the subsidiary.
- The nature of subsidiary's business.
- Types and amounts of inter-company transactions.
- Types and amounts of purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations.

- Types of services the subsidiary performs for the bank or other related organizations.
- The bank's outstanding contingent liabilities in favor of the subsidiary.
- The bank's potential contingent liabilities, morally or legally, as a result of lawsuits pending against the subsidiary.

Often statutory subsidiaries also meet the definition of some other subsidiary type, and the examining criteria for the latter would then apply.

Agricultural Credit Corporations

The increasing number of agricultural credit corporations and their effect on parent banks has intensified the need for the supervision of those corporations. Most agricultural credit corporations come under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where they discount most of their loans. However, a corporation may obtain funds exclusively in the open market and avoid FICB regulation.

Normally, the examiner-in-charge decides when to examine an agricultural credit corporation and should always perform a complete analysis of its activities if:

- The corporation is not supervised by the FICB.
- The most recent FICB examination occurred over a year ago.
- The most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of:

- Asset quality.
- The volatility, maturity, and interest rate sensitivity of the asset and liability structures.
- The bank liability for guarantees issued on behalf of the corporation.

The consolidation procedures listed in the Instructions for Preparation of Consolidated Reports of Condition and Reports of Income should be used when consolidating the figures of the corporation with those of its parent.

Edge Act and Agreement Corporations

Edge Act and Agreement corporations are U.S.-based corporations that engage in international and foreign banking or hold stock in foreign banks. Permissible activities for such subsidiaries are described in detail in Regulation K of the Board of Governors of the Federal Reserve System. They have the power, with supervisory consent, to purchase and hold the stock of foreign banks or international companies.

Examiners of the Federal Reserve examine edge Act and Agreement corporations, and their reports of examination should be reviewed during each examination of a parent national bank. The Federal Reserve examiner's report and the amount and quality of paper held by such corporations must provide the basis for evaluating the bank's investment in these corporations.

Transactions between the parent bank and its Edge Act and Agreement corporation subsidiaries are not subject to the limitations contained in 12 USC 371c. However, they are subject to limitation under 12 USC 601 and Federal Reserve Board regulations.

Domestic Subsidiaries

Domestic subsidiaries are any majority owned companies, other than Edge Act or Agreement corporations, domiciled in the United States and its territories and possessions. Such subsidiaries may be either operating or statutory.

Foreign Subsidiaries

Foreign subsidiaries are any majority-owned companies domiciled in a foreign country or any Edge Act or Agreement corporation. Under 12 CFR 20, the OCC requires a 30-day notice prior to the acquisition, establishment, or disposition of an Edge Act corporation, Agreement corporation, or a foreign bank. Also, 12 CFR 211.7 requires effective systems of records, controls, and reports that keep the bank's management informed of the activities and conditions of its subsidiaries.

On-location examinations of these and lesser-owned subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in countries such as Switzerland, Singapore, Luxembourg, and the Bahamas also preclude on-the- spot examinations. In instances where on-location examinations cannot be performed, foreign subsidiary reports submitted according to 12 CFR 211.7 (Regulation K) and to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Significant Subsidiaries

Significant subsidiaries, as used in the consolidation instructions for certain regulatory reports, refers to subsidiaries which meet any one of the following tests:

- It is a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts.
- It is a majority-owned subsidiary for which the bank's share of the gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues.
- It is a majority-owned subsidiary whose "income (loss) before income taxes" amounts to 5 percent or more of the parent bank's "income (loss) before

income taxes."

- It is a majority-owned subsidiary that is the parent of one or more subsidiaries which, when consolidated, constitutes a "significant subsidiary" as defined above.

Associated Companies

Associated companies are ones in which the bank directly or indirectly owns 20 to 50 percent of the outstanding common stock, unless the bank can rebut to the OCC the presumption of exercising significant influence. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in such companies are generally appraised like commercial loans by a credit analysis of the underlying financial information.

Other Related Organizations

Other related organizations include companies in which the bank, its parent holding company, or non-bank affiliate does not necessarily have any direct investment, but which the bank sponsors and/or advises in its activities. The most notable examples are the real estate investment trusts. Transactions between the bank and other related organizations may be subject to the limitations in 12 USC 371c. In most cases, because of non-ownership or less-than-majority ownership, legal authority to conduct an examination does not exist.

Bank Holding Companies

Bank holding companies are defined by 12 USC 1841 as any company that has control over any bank through direct or indirect ownership. The statute defines the word "control" as holding 25 percent of outstanding stock; however, there are certain exceptions to that rule in the statute.

A bank and its parent holding company are considered affiliates when the holding company owns more than 50 percent of the bank's capital stock, votes more than 50 percent of the bank's capital stock at an election, or has a majority of its directors that are directors of the bank. Transactions between the bank, its holding company, and its holding company affiliates ordinarily are subject to the limitations in 12 USC 371c.

Transactions between subsidiary banks that are 80 percent or more owned by the same holding company are not subject to the qualitative limitations or collateral requirements. However, those banks are prohibited from purchasing low quality assets from each other. In addition, transactions between them must be made on terms and conditions that are consistent with safe and sound banking practices.

Under 12 USC 481, the OCC has authority to examine bank holding companies and most of their non-banking subsidiaries that are affiliated with national banks. Examinations of parent holding companies and non-bank affiliates are conducted in conjunction with the examination of the bank when the OCC deems it necessary to determine the nature and extent of interaction between a bank and its non-bank affiliates and parent holding company.

When a national bank's holding company and its non-bank subsidiaries are not examined, the examiner can still obtain pertinent information regarding those relationships by reviewing the holding company's annual report (Form 10-K), quarterly report (Form 10-Q), and report of certain events or changes (Form 8-K). Those reports, which contain financial statements and other information, are required to be filed with the Securities Exchange Commission pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

In Banking Circular 57 dated July 1, 1976, the Comptroller of the Currency requested that each national bank subsidiary of a holding company maintain a copy of Form 10-K at its main office for review by examiners. Form 10-K includes information such as identification of each class of securities, number of shareholders, identification of all subsidiaries, and financial statements (usually certified). Form 10-Q contains unaudited financial data and other information similar to that requested in Form 10-K. Form 8-K is filed after any of the following events:

- Changes in control of registrant.
- Acquisition or disposition of assets.
- Legal proceedings.
- Change in securities.
- Changes in security (i.e., collateral for registered securities).
- Defaults upon senior securities.
- Increase in the amount of securities outstanding.

- Decrease in the amount of securities outstanding.
- Options to purchase securities.
- Revaluation of assets or restatement of capital share account.
- Submission to matters to a vote of security holders.
- Newly enacted requirements affecting registrant's business.
- Other materially important events.
- Financial statements and exhibits.

The examiner may wish to review forms Y-6 and Y-8 to obtain useful information about the holding company and its subsidiaries. The holding company files those forms with the Federal Reserve. Form Y-6, filed annually, contains information on each subsidiary, both bank and non-bank, activities of the parent holding company, and financial statements. Form Y-8, filed quarterly, details inter-company transactions between the holding company and its subsidiaries.

Evaluation of Related Organizations

In order to properly evaluate affiliates and other related organizations relative to the overall condition of the bank, the examiner must:

- Know the applicable laws, rulings, and regulations that define and establish limitations with respect to loans to, investments in, and extensions of, credit to affiliates.

- Make a thorough analysis of the propriety of the related organizations' carrying value, the nature of the relationship between the bank and its related organizations, and the effect of such relationship upon the affairs and soundness of the bank.

Equity accounting requires at least quarterly adjustments to the bank's "investment in subsidiaries" accounts for the bank's proportionate share in the net assets of each subsidiary and associated company. That adjustment will represent a charge or credit to current income to reflect the bank's proportionate share of the net income or net loss of the subsidiary or associated company.

The requirement for equity accounting is applicable to all financial reports of national banks, including those required under 12 CFR 11 (Securities Act Disclosure Rules) and 12 CFR 18 (Form and Content of Financial Statements). Since such reports are required to give a “true and correct” picture of the reporting bank’s books, the equity accounting method necessitates book adjustments to the carrying value of each investment.

In the event a bank has failed to make the appropriate adjustments on its books as required by the equity method of accounting, the examiner should discuss the matter with management for prompt corrective action and note it in the report of examination under violations of laws, rulings, or regulations.

Equity accounting does not apply to investments in foreign subsidiaries whose income is not remittable. The bank should carry investments in those subsidiaries at cost or at fair market value, whichever is lower.

Goodwill results from the cash purchase price of a corporation being in excess of the book value of that corporation. National banks may book goodwill as another asset.

Examiners determine the propriety of the carrying value of a bank’s investment in any related organization by evaluating the balance sheet and operating statement of the company in which the bank has the investment. At times, that may not seem important to the overall condition of the bank, because the amount invested may not be large relative to the bank’s capital funds. It may appear that a cursory appraisal of the company’s assets would therefore be sufficient. However, the opposite is often true. Even though a bank’s investment in a subsidiary or associated company is relatively small, the underlying legal obligation may be substantial and may greatly exceed the total amount of the reported investment.

When examining and evaluating the bank’s investment in, and loans to, related organizations, classified assets held by such companies should first be related to the capital structure of the company and then be utilized as a basis for classifying the bank’s investment in, and loans to, that company.

One problem that may be encountered in attempting to make the asset evaluation of some subsidiaries and associated companies is that of inadequate on-premises information. That may be especially true of foreign investments, statutory subsidiaries, and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-upon standards for that information in the future. The examiner must insist that the bank have adequate supporting information available or readily attainable in the bank and that the information be of sufficient quality to allow an informed evaluation of bank's investment.

Bank management and regulatory authorities must be informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, that they have some on-premises control of the company, such as board representation, and that they have audit authority. In the case of an associated company, that implies that the bank should participate in company affairs to the extent practicable.

Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office. That information can best be obtained through full audits by reputable certified public accountants.

For foreign subsidiaries, in addition to audited financial information prepared for management, the bank should have on file:

- Reports prepared in conformance with Federal Reserve regulation 12 CFR 211 (Regulation K).

- Reports prepared for foreign regulatory authorities.

- Information on the country's cultural and legal influences upon banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation.

The bank must fully disclose intercompany transactions and relationships, and examiners must determine their propriety. Examiners must also determine the propriety of payments for services rendered; payments for facilities used, such as premises, personnel, or equipment; or payments for assets sold. A major difficulty in determining transactional relationships among all national bank affiliates exists when some banks in the holding company are unapproachable directly by the OCC because they operate under state charters. However, difficult as it may be, the examiner must review and evaluate the quality and nature of loans, investments and future commitments, and fees paid or received between a bank and its related organizations to determine:

- Adherence to statutes, rules, and regulations.
- Effect on the bank's earnings and liquidity.
  - Reasonableness of any costs incurred.
  - The bank's ability to afford such cost.
- Overall soundness of the relationship.
  - The necessity of the service or asset.
  - The level of competence of the service or quality of the asset.

In addition to determining the effects of intercompany transactions, the examiner must also determine if such related organizations are detrimental to the bank because they generate adverse publicity, engage in illegal activities, or cause a conflict of interest for an officer or director.

Information about related organizations and interlocking directorates and officers can be obtained from SEC forms 10-K and 10-Q, OCC forms F-2 and F-4 or other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with 12 CFR 215. By reviewing the information, the examiner should be able to identify all credit relationships between the bank and affiliated interests of those officials, and to determine whether such relationships are within the statutory limits in amount and whether they are fair from the bank's standpoint.

Within certain limits, the separate corporate existence of non- bank affiliates provides a legal screen between the bank and its affiliates. However, cases in recent years demonstrate that difficulties with a holding company or its non-bank subsidiaries can be detrimental to the bank. Thus, the condition and operations of related organizations must be carefully reviewed when determining the condition of the bank. An examination keeping that in mind will help lessen the possibility that problems arising in particular related organizations will lead to unforeseen problems for the bank.

Bank Holding Company Operation

Many banks have formed or joined bank holding companies for the obvious attendant advantages. However, there may be some aspects to a bank holding company operation, (*i.e.*, a conglomerate consisting of bank and non-bank subsidiaries), of which an examiner should be aware. Those factors help determine whether the holding company structure has strengthened the individual bank by providing financial support, diversification, benefits of scale, and specialized management support, or has weakened the bank by causing concentration of credit, failure to conform to bank policy, and lack of sufficient management talent. Important factors are:

- *Management*—The formation of a bank holding company generally has a positive impact on bank management because it results in greater availability of expertise. The bank holding company structure can add greatly to the individual bank management by furnishing experts in many diverse areas. In some instances, however, the expansion and diversification of bank holding companies ultimately forces affiliated bank management to follow one of the following three detrimental courses:

  - Moving to the bank holding company, thus leaving a void in bank management.
  - Remaining in the bank, thus forcing the bank holding company to seek competent managers outside, which may be quite difficult because of the need for a banking background, as well as a thorough understanding of the problems inherent in managing a diverse bank holding company.
  - Maintaining a dual role in both entities, which many managers find spreads them too thin and causes their performance in both capacities to suffer.

  It is important, therefore, for the examiner to consider the impact of holding company management on the bank under examination.

- *Financial Support*—The holding company structure can provide its subsidiary bank strong financial support because of its greater ability to attract and shift funds from capital surplus to capital deficient areas and to enter lucrative consumer and industrial markets on a wider geographical area than would otherwise be permitted. That financial support may take the form of equity capital and/or funding of loans and investments. However, when the financial condition of the holding company or its non-banking subsidiaries is unsound, the operations of its subsidiary bank can be adversely affected. In order to service its debt, or to provide support to another subsidiary which is experiencing financial difficulty, the holding company may siphon inordinate amounts of funds from its bank subsidiary by encouraging its bank subsidiary to:

- Engage in high risk investments to obtain increased yields.
- Purchase/swap its high quality assets for the parent's or other affiliate's lower quality assets.
- Enter into inter-company transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services.
- Pay excessive dividends.

Even when the holding company's structure is financially sound, the holding company's ability to sell long-term debt and to pass the proceeds down to its bank subsidiary in the form of equity capital still may present problems. That procedure, frequently referred to as "double leveraging," does increase the subsidiary's equity capital. The holding company usually services its debts out of dividends from the subsidiary, and if the subsidiary encounters an earnings problem, it may not be able to pass dividends up to its parent. Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with the proceeds. That procedure may cause a liquidity problem if the maturities of the commercial paper sold and loans bought are not matched.

Holding company debt also may affect subsidiary banks adversely if the subsidiaries are required to maintain compensating balances to support the holding company's debt. In the typical transaction, a holding company (or a non-bank subsidiary of a holding company) has a loan outstanding with a nonaffiliated bank. As a condition for granting the loan, the nonaffiliated bank required a compensating balance provided by the holding company's subsidiary bank. Such a transaction should be cited as an unsafe and unsound banking practice when the holding company provides insufficient compensation to its subsidiary bank for the use of the funds. When the bank placing the deposit receives adequate compensation, and other unfavorable factors such as undue commitments of deposits to support holding company borrowings, are absent, the transaction need not be criticized.

- *Taxes*—In filing a consolidated tax return, a holding company may collect funds representing each subsidiary's share of the taxes due. A bank's cash transfers to/from a holding company in connection with a consolidated income tax obligation should:

- Not exceed an amount based upon the amount of taxable income or loss the bank would have reported had it filed a separate return.
- Be made only at such time as necessary to reasonably permit the holding company to make required estimate payments or final settlements with the IRS.

A transfer of deferred taxes by the bank to the holding company is considered an unsafe and unsound banking practice. The bank receives no real benefit from such a transfer. In addition, such transfers reduce bank liquidity and potential earnings unnecessarily because deferred income taxes would not otherwise have been paid.

A banking subsidiary that is operating at a loss for income tax purposes should be reimbursed in cash by the holding company to the extent there is a tax benefit. The tax benefit is determined in a manner consistent with the allocation of tax expense to profitable subsidiaries from those losses on the consolidated tax return.

Transfer of deferred taxes, or early payment of taxes currently due IRS, by a bank to its holding company, are extensions of credit subject to 12 USC 371c because the amounts transferred are not immediately due and payable to IRS.

- *Diversification and Control*—In order to insure orderly expansion and diversification, there must be adequate coordination among the banking and non-banking related organizations. The organizations must establish sound internal controls to insure that the geographically dispersed operations follow stated procedures and policies.

  The coordination of policies and adequate internal controls are particularly important in the lending area. A major benefit to the individual bank in belonging to a multibank holding company is that it can better serve its customers by participating loans that would exceed its legal limit. However, that ease in participating loans can, without the proper policies and controls, expose the entire corporate family to two hazards. The first hazard relates to management's ability. Loans may be approved that are beyond the individual bank's lending limit and beyond the management expertise of any of the participants. The second hazard relates to credit concentration. For multibank holding companies actively involved in the operations of their affiliate banks, it is possible that the absence of good communication may result in an undue concentration of credit. The problem of credit concentration can be further heightened when non-bank affiliates, such as mortgage or leasing companies, are involved. Executive compensation in those industries is historically based on volume, and, thus, there is a tendency to lend heavily to one particular customer, or type of customer, who has operated successfully in the past.

A concentration of credit may develop where non-banking affiliates are extending credit to the same customers or industries as their affiliated banks. Such a concentration may also develop when non-bank affiliates, searching for profits and in the absence of banking regulations, extend credit imprudently to the same customer or industry.

As a minimum, in addition to establishing an overall lending policy which would bring banking and non-banking related organizations under a set of common controls so that overall operations will be consistent with executive management's philosophies and procedures, a loan participation report should be prepared periodically. That report should include a listing of aggregate loans to a single borrower granted by two or more affiliated entities within the holding company group.

Management and Other Fees

Banks often obtain goods and services from shareholders and insider-related organizations. The arrangement may benefit the bank since the supplier may offer lower costs because of economies of scale such as volume dealing. Furthermore, banks may be able to purchase a package of services which otherwise might not be available. However, because of the interrelationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received.

Fees paid by the bank to shareholders or insider-related organizations should have a direct relationship to and be based solely on the fair value of goods and services provided. Fees should only compensate the supplier for providing goods and services which meet the legitimate needs of the bank.

The OCC has notified national banks that they should retain satisfactory records that substantiate the value of goods and services received, their benefit to the bank, and their cost efficiencies. There are no other minimum requirements for records. Yet, an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of three methods:

- Reimbursement for cost of goods or services.
- Cost plus a reasonable profit margin.
- Comparative fair market value.

Any of those methods may be acceptable to the OCC, as long as the bank can substantiate that the fees paid are reasonable for value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain. Moreover, a holding company may be able to offer a number of services on a cost basis to a subsidiary bank, any one of which might be contracted elsewhere for less; yet, in the aggregate, they may be cost efficient or accommodate economy of scale for the entire organization. However, OCC does not sanction payment of excessive fees by one or more subsidiary banks based upon their ability to subsidize other unprofitable operations.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses which may be passed on to a national bank.

Generally, OCC considers payment of excessive fees an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors and include appropriate criticism in the report of examination. When prior payment of excessive fees results in additional taxes for the bank, the recipient or the directors responsible for approving the fees should pay the taxes.

Real Estate Investment Trusts (REIT)

A REIT is considered a related organization if it is sponsored and/or advised by the bank itself, its parent holding company, or a non-bank affiliate. Because a

REIT frequently carries a name that closely identifies it with its sponsoring bank or bank holding company, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

Transactions between a bank and an affiliated REIT are subject to the requirements of 12 USC 371c. A REIT is considered a bank affiliate if it is sponsored and advised on a contractual basis by the bank or its subsidiary or affiliate.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interests and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling or swapping questionable assets to their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

Regulatory Authority

To properly evaluate the bank, its holding company, subsidiaries, and affiliates, both on an individual basis and as a corporate family, the examiner should be aware of the federal and state regulatory authorities involved. Under statute, the Federal Reserve has primary jurisdiction over bank holding companies. Although the OCC has authority to examine bank holding companies and most other entities affiliated with national banks, (exceptions are state chartered banks which are members of the Federal Reserve System and foreign banks), the Federal Reserve Board (FRB) regulates them, i.e., approves or disapproves applications and supervises.

The FRB examines and regulates state chartered bank subsidiaries that are members of the Federal Reserve System. The Federal Deposit Insurance Corporation (FDIC) examines state chartered insured bank subsidiaries which are not members of the Federal Reserve System, and the state banking authorities regulate them. National bank examiners may not examine affiliate state non-member banks without the district’s prior approval.

Edge Act and Agreement corporations and foreign banks and subsidiaries are examined and regulated by the Fed and/or foreign banking authorities. The OCC examines foreign branches of national banks, but the FRB regulates them.

Although the division of authority described above is intricate, it does not mitigate the importance of the examiner analyzing the bank and its related organizations as a single entity.

During the pre-examination analysis of the bank, a determination of which related organizations are to be examined in depth should be made. The criteria for that determination are:

- All operating subsidiaries must be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the OCC under the provisions of 12 USC 486.

- Statutory subsidiaries are examined except when relationships between the subsidiary, its parent, and other related organizations is fully disclosed by material on hand, and the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination to examine a subsidiary are:

  – The bank's percent of ownership and dollar amount of investment in the subsidiary.
  – Nature of the subsidiary's business.
  – Types and amounts of intercompany transactions.
  – Types and amounts of purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations.
  – Types of services performed by the subsidiary for the bank or other related organizations.
  – Outstanding contingent liabilities by the bank in favor of the subsidiary.
  – The bank's potential contingent liabilities, moral or legal, as a result of litigation, claims, or assessments pending against the subsidiary.

  In many instances, statutory subsidiaries also meet the definition of some other type of subsidiary, and the examining criteria for such subsidiaries then apply.

  Parent holding company and non-bank affiliates are examined in conjunction with the examination of the lead national bank when the OCC deems it necessary to determine the nature and extent of interaction between a bank and its non-bank affiliates and parent holding company. Factors to be considered in making the determination to examine are:

- Dollar amount of loans or advances by the bank.
- Nature of business of the non-bank affiliates.
- Types and amount of intercompany transactions.
- Types and amounts of assets purchased, sold, or swapped.
- Types of services performed for or by and fees paid or received.
- Outstanding contingent liabilities by the bank in favor of its parent or non-bank affiliates.

Factors which should be considered in making the determination to examine non-banking subsidiaries within the parent holding company under examination are:

- When total assets of subsidiary are equal to 10 percent or more of consolidated net worth of the holding company.
- Subsidiaries net profits or losses equal 5 percent or more of consolidated gross operating revenue of holding company.

The following procedural steps should be performed in all banks that have related organizations:

1. Complete or update the Related Organizations section of the Internal Control Questionnaire.

2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.

3. Obtain the following reports and/or forms which, where appropriate, were prepared or filed since the preceding examination:

   a. Annual report on Form 10-K or Form F-2.

   b. Current report on Form 8-K or Form F-3.

   c. Quarterly report on Form 10-Q or Form F-4.

   d. Quarterly report on Form Y-8.

e. Annual report on Form Y-6.

f. Annual Report to Shareholders.

g. Required reports under Federal Reserve regulations K and M and to foreign banking authorities for foreign subsidiaries.

h. Subsidiary and affiliate reports prepared by examiners.

i. Fed reports of examination for non-banking subsidiaries.

(All national banks that are holding company subsidiaries are required to have on file Form 10-K.)

4. Request that the bank complete the following schedules:

   a. Related organizations.

   b. Transactions with related REITs.

   (Unless the bank is the largest national bank in the holding company, the examiner should first ascertain the necessity of having the bank complete the schedules for all holding company subsidiaries. The extent of the relationships should be determined from review of reports and forms obtained in step 3 and discussions with management. Schedules should be completed for those related organizations with which the bank has financial transactions or for which services are being provided.)

5. Circulate a list to examiners assigned to each bank department setting forth the names of the related organizations and the loans to and investments in these organizations. The accuracy and completeness of this information should be verified.

6. Obtain information concerning receivables from or payables to related organizations from examiners assigned to “Other Assets and Other Liabilities.”

7. Review the bank’s files and reports obtained in step 3, and transcribe pertinent financial data and comments regarding related organizations.

8. Review fees paid by the bank to related organizations, bank insider-related organizations, and stockholders, and determine that they represent reasonable reimbursement for goods and services received by:

   a. Determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value).

   b. Reviewing documentation maintained by the bank substantiating the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected.

   c. Comparing schedule of fees currently in effect to those in effect 12 months ago.

   d. Comparing the fees paid during the last 3 months to those paid for the same period one year ago.

9. Based on the information obtained above, review and comment on the following for each related organization:

   a. The quality of loans, investments, and future commitments to any related organization.

   b. The nature and volume of transactions between the related organization and the bank and:

      - Extent of any purchase, sale, or swap of assets between the bank and the related organizations and the propriety of the transaction and related consideration.
      - Fees such organizations charge the bank for services rendered and the reasonableness of those fees.
      - Cash transfers to or from a related organization in connection with a consolidated income tax obligation. (Amounts paid should be based on that amount due if a separate return was filed. They should be paid only at such time to reasonably permit required estimated payments or final settlements to be made to the IRS.)
      - Fees received by the bank from such organization for use of bank personnel, premises, marketing services, and equipment, etc., and the adequacy of those fees.

- Any agreements, guarantees, pledges, or hypothecations between the bank and any related organization, and if they are properly reflected on the books of the bank, and whether there are any exploited conflict of interest situations.

c. Litigation where the related organization is a defendant in a suit, and if the litigation could have an adverse effect on the bank (from Form 10-K or other source).

d. Each interlocking officer and/or director relationship as shown on the schedule obtained in step 4 and:

- Whether fees or salaries are excessive for duties performed.
- If adequate time is devoted to management responsibilities.

10. Determine compliance with laws, rulings, and regulations pertaining to related organizations by performing the following for:

a. 12 USC 371(c)—Loans to Affiliates.

- Determine which affiliates are exempted from these statutory requirements.
- Calculate 10 percent of capital stock and unimpaired surplus.
- For each affiliate to which this statute is applicable, determine:
  - Advances exceeds the 10 percent lending limit.
  - If each loan or extension of credit to an affiliate is secured by collateral in the required form and amount.
- For all affiliates to which this statute is applicable, determine if the aggregate amount of loans, investments, and advances exceeds 20 percent of capital stock and unimpaired surplus.

b. 12 USC 221(a)—Affiliates and 12 USC 375(a)—Loans to Executive Officers:

- Obtain lists of loans to executive officers and business interests of directors, executive officers, and principal shareholders from examiner assigned "Duties and Responsibilities of Directors."
- Determine accuracy and completeness of list as it concerns related organizations by comparing it to information obtained from management and other examiners.

- Investigate to determine undisclosed affiliate relationships if there are several directors or officers who have a common interest in the same entity by:
  - Obtaining a listing of all directors for the entity which is suspected of enjoying an affiliate relationship.
  - Reviewing authorizing signatures on corporate resolutions to borrow.
  - Reviewing signatory authorities on deposit signature cards.

c. 12 CFR 11—Securities Exchange Act Disclosure Rules, and 12 CFR 18—Form and Content of Financial Statements:

- Determine which subsidiaries and associated companies are exempt from the equity method of accounting.

- Determine, for each subsidiary and associated company for which the equity method of accounting is applicable, that carrying values are adjusted, at least quarterly, to reflect the bank's proportionate share of the net income or net loss of the subsidiary or associated company.

11. If the bank operated a travel agency, determine that it has divested itself of that activity.

12. If the bank is a subsidiary of a holding company and the parent has sold commercial paper and funded bank loans with the proceeds, obtain or prepare the following schedules and forward them to the examiner assigned "Funds Management":

    a. Amount and maturities of commercial paper outstanding.

    b. Amount and maturity of assets that paper supports.

13. If the bank is a subsidiary of a holding company and the parent has sold long-term debt and passed the proceeds down to the bank in the form of equity, obtain or prepare the following schedules and forward them to the examiner assigned "Capital Accounts and Dividends":

    a. Amount, maturity, and repayment terms of long-term debt sold.

b. Amount of equity capital passed to bank.

c. Expected minimum dividend payment required by bank to service debt of parent.

14. Determine, from the results of previous steps and discussion with management, if there are any anticipated changes in related organization/bank relationship that may possibly have adverse effects upon the affairs and soundness of the bank.

15. Based on the above steps, comment on the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship upon the affairs and soundness of the bank.

16. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, consider the necessity of an in-depth examination of related organizations. Perform appropriate procedures in step 17, and develop specific procedures based on type and scope of activities being conducted.

17. The following procedures should be considered where an in- depth examination of the holding company and its non-bank subsidiaries is deemed appropriate (the examiner-in-charge should confer with the regional administrator before undertaking such an examination):

    a. Review and evaluate loan and investment quality of the parent corporation and non-bank subsidiaries (use procedural steps from other programs such as “Investment Securities,” “Commercial Loans,” etc.), and:

        - Appraise the quality of the loan portfolio and investments.
        - Review activity in and adequacy of valuation reserve.
        - Analyze frequency and circumstances of all asset transfers and loan participations between parent and non-bank subsidiaries and between parent and bank subsidiaries, if applicable.
        - Review non-accrual policies of the holding company for significant distortions and comparability.

- Review and evaluate future commitments, and detail them by subsidiary.
- Detail concentrations of credit to individuals and/or groups or industries, if evident.

b. Review and analyze the liability structure of parent corporation and non-bank subsidiaries.

   For the parent corporation:

   - Review and appraise types and levels of indebtedness (maturities, rates, creditor concentrations, etc.).
   - Review covenants relating to debt instruments, and assess corporation's future debt capacity.
   - Review and appraise short-term funding strategy and patterns, and:
     - Analyze commercial paper operations (marketing, etc.).
     - Review adequacy and availability of bank backup lines for commercial paper.
     - Review and detail arrangements involving compensating balances maintained by subsidiary banks to secure backup lines with other banks.
     - Review and note restrictions to bank line usage.
     - Review and comment on maturities of debt being incurred and assets being funded.
   - Review corporate records, and note capital commitments to regulatory agencies, contingent guarantees of subsidiary indebtedness, and contingencies arising from litigation.

   For non-bank subsidiaries:

   - Review and appraise any funding agreements with parent corporation.
   - Review and appraise any funding agreements with, and debt instruments issued to, outside creditors.
   - Review agreements with third parties involving outright purchase of assets to determine liability for repurchase of assets or any other contingent liabilities.
   - Review and assess debt structure with attention to matching of debt and asset maturities.

c. Analyze cash flow, earnings, and tax policies of parent corporations and non-bank subsidiaries.

For parent corporation:

- Evaluate cash stream, and prepare schedule of payments to corporation by subsidiaries. Compare 3 previous fiscal years and current year-to-date with previous year-to-date.
- Obtain, from management, written policies for the assessment of management/service fees and dividends from subsidiaries and prepare a schedule of such payments by the subsidiary for the past 3 fiscal years, comparing year-to-date with previous year- to-date.
- Comment on the reasonableness of fees relative to the cost of services rendered.
- Review the corporation's policy for handling tax benefits and remittances by subsidiaries.
- Prepare a schedule depicting parent net income, less equity in undistributed income of subsidiaries, plus interest expense, divided by interest expense for past 3 fiscal years, and compare year-to-date with previous year-to-date.
- Review parent's dividend policy, comment on its impact on subsidiary operations and prepare a schedule showing dividend payout for 3 prior fiscal years, and compare year-to-date with previous year-to-date.

For non-bank subsidiaries, prepare cash flow statements for previous 3 fiscal years, and compare current year-to-date with previous year-to-date.

d. Review and evaluate capital adequacy by:

- Relating the consolidated classified assets of the subsidiaries against the consolidated net worth, or relating classified assets proportionately to the parent's investment in and advances to each subsidiary.
- Commenting on overall capital structure of both parent corporation and specific non-bank subsidiaries, as warranted.
- Discussing adequacy of capital with management and noting management's future plans to raise capital.

e. Review and evaluate management and control policies within the holding company by:

- Reviewing parent corporation board meeting minutes and assessing director interest in and awareness of affiliates.
- Reviewing and evaluating corporate management's internal audit procedures for those policies.
- Reviewing "management letters" from certified public accountants about those internal controls.
- Reviewing shareholder records, noting significant concentrations and, in cases where officers/directors are involved, noting any undue influence with regard to policies, practices, and procedures.

f. Review management's future operating plan for the holding company, and:

- Analyze subsidiary's earnings and capital projections for 1 and 5 years.
- Obtain underlying assumptions for:
  – Return on assets.
  – Dividend retention rate.
  – Asset growth rate.
  – Capital growth rate.
- Compare projections against past operating performance, and comment on plan.

18. Discuss findings and conclusions reached in the examination(s) of the holding company and any non-bank subsidiary with management of those entities. Prepare a separate report of examination where an in-depth examination was performed.

19. Prepare, in appropriate report form, and discuss with appropriate management:

a. The adequacy of written policies on related organizations.

b. The manner in which bank officers are operating in conformance with established policy.

c. Violations of laws, rulings, or regulations.

d. Impropriety of any transaction between the related organization and the bank.

e. Loans to and/or investments in related organizations, which for any reason, the examiner questions quality, carrying value, or ultimate collection.

f. Litigation, commitments, contingent liabilities, and/or current or anticipated changes between the bank and its related organizations that may have adverse effects on the affairs and soundness of the bank.

g. Interlocking officer and/or director relationships that are detrimental to the bank under examination or any of its related organizations.

h. Any other information which will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank under examination.

i. Recommended corrective action when policies, practices, or procedures are deficient.

20. Consolidate information contained in the operating subsidiary report(s) for inclusion in the report of examination.

21. Consolidate financial information and any other comments concerning related organizations for which a separate report was not prepared for inclusion, where appropriate, in the report of examination, and:

    a. If the bank is the largest subsidiary national bank in a bank holding company, the most recent fiscal year-end statements of the holding company, a maturity schedule of short-term debt instruments outstanding, and a listing of bank affiliates and activities also should be included in the appendix to the report.

22. Prepare a memorandum, and update the work program with any

information that will facilitate future examinations.

Related Organizations (Section 407) Internal Control Questionnaire

Review the bank's internal controls, policies, practices, and procedures concerning related organizations. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

Related Organization Policies and Objectives

1. Does the bank have written guidelines with regard to expansion of services through the formation and/or acquisition of related organizations?

2. To determine that established objectives and policies are adhered to:

   a. Is there an overall lending policy that would bring banking and non-banking related organizations under a common set of controls?

   b. Are bank officials an integral part of subsidiary or related company management?

   c. Can operating procedures be monitored from available internal or external audit reports?

3. Are periodic independent reviews performed to assess bank management objectives and policies with regard to the current status of their association with the related organizations?

4. Does bank management have an active role in the related organizations audit committees, or do they retain the right to examine the companies' records including the right to receive third party letters from the external auditors?

5. Are policies and procedures such that the effect upon the bank's liquidity is monitored when commercial paper or other proceeds are used to fund bank loans?

Related Organization Records

6. Are records maintained for the companies in which the bank has a capital investment including foreign ones so that a determination can be made of the extent of bank control, quality of assets, profitability of the company, and legality of operations?

7. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in, and other extensions of credit, security pledged, obligations of any affiliate which is used as collateral security for advances made to others, commitments, and litigation)?

8. Does the bank maintain a copy of all internal and/or external audit reports, including management letters and responses, of the subsidiary or related company?

9. In the case of registered bank holding companies and non- bank affiliates arising through the holding company relationship, are copies of forms 10-Q, 10-K, 8-K, Y-6, and Y-8 available for review?

10. In the case of Edge Act and Agreement corporations and foreign subsidiaries, are copies of Federal Reserve examination reports and foreign regulatory reports available for review?

11. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences upon banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?

12. Is the carrying value of all subsidiaries and related companies accounted for on the equity basis and adjusted, at least quarterly, to reflect the reporting bank's cumulative share of the company's earnings or losses?

13. Is an objective review performed of the benefits or quality of assets received relative to the cost incurred?

14. Are money transfers between bank and any related organization adequately documented to justify the equity of the transaction?

Conclusion

15. Is the foregoing information considered an adequate basis for evaluating internal controls in that there are no significant additional accounting controls, administrative controls, or other circumstances that mitigate any weaknesses indicated above, and there are no other circumstances that impair any controls (explain negative answers briefly)?

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered ________________ (good, medium, or bad).